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The Economics of Tort Law: A Hurried and Partial Overview

Richard A. Epstein

JUDGE RUDOLPH GERBER: Good afternoon. It is my pleasure to introduce to you, Richard Epstein. Richard has been a friend of mine for many years now. He is the James Parker Hall Distinguished Service Professor at the University of Chicago School of Law. Throughout his career, he has been a leader in the development of law in economics as a field. He served for many years as the editor of the *Journal of Legal Studies*, which had an important impact on my career. He was an amazingly active editor with the *Journal of Legal Studies*. He is now one of the editors of the *Journal of Law and Economics*. Both of those journals are viewed as the top journals in law in economics, and both are from the University of Chicago. Richard is a prolific scholar who has written in a wide number of areas, including some very influential books dealing with property rights, government takings of property, and regulatory takings issues. He has recently been writing about health care issues. He has written articles and books on affirmative action, taking what would be fairly described as a politically incorrect or courageous stance in many areas, and he has, throughout his career been working on tort law and products liability issues. He has also published many articles, a casebook, and a treatise, I believe, in those areas, and he was a natural person to come here and quickly summarize some of the economics of tort law. In the process of signing up Richard for this, I identified a couple of people who were willing to take him on. As it turned out, I could not quite get them on board, so I want all of you to be thinking of questions to follow up with Richard for after his presentation. So let us please welcome, Richard Epstein.

PROFESSOR RICHARD EPSTEIN: I am supposed to talk to you today about the role of economics, and economic analysis in law. I approach this with a certain degree of schizophrenia when I get on the podium, whether I am to treat the subject as a critic of the field— which I thought I started out as some years ago— or whether I have become one of its leading exponents, which some people have since attributed to me. I am really not quite sure whether I am for or against it, but I am sure about one thing—the categorization really does not make much of a difference. The important thing that one wants to do is to figure out, actually, whether you have something to say about the field. If some of it turns out to be mildly sympathetic to the field, then so be it. If some of it turns out to be harshly critical, then that is going to be true. The important thing is to be

**MODERATOR: Honorable Rudolph J. Gerber, Arizona Court of Appeals.
Richard A. Epstein, James Parker Hall
Distinguished Service Professor, University
of Chicago School of Law.**

difficult to categorize. I think that is probably the essence of anybody who wants to give a speech of this particular sort. Being difficult to categorize is very nice before a bunch of judges here, because now in effect, in my own particular guise you cannot tell whether I am a plaintiffs' lawyer or a defendants' lawyer, and that is because I myself do not know.

That being said, I think there is—whenever you deal with the subject of law and economics—a normative and a positive side to this profession. On the one hand, you ask the question, “Well, I’ve been trying to look at the way in which the field has operated, and to what extent does the field of law and economics have some influence on the way in which judges decide particular cases?” What you are doing is making a descriptivist theory about the way in which judges talk, either consciously or unconsciously, about their subject matter. Then the second version of the subject, I think, is probably the more normative version, which asks the question, “If I were an Article III judge—which you can be sure I will never be—what would I do with my judicial power? Or if I were a legislator, in order to craft the field, which would answer or respond to the dictate of what law and economics seems to require.”

The moment you start to put the questions in this particular fashion, I think you have to be aware of a subtle transformation that has happened, which is: the field today is much less monolithic than it was probably thirty or forty years ago. It used to be associated with the University of Chicago, with *laissez faire*, with assumption of risk, and now, of course, it turns out that other people have entered into the field, and some of them actually have what you might call “center” and “left of center” tendencies. So, there is probably much less of a common view as to what is law and economics, and it is much more difficult for you to locate a distinct political coloration. Even with folks like myself who certainly are regarded as notoriously and outrageously conservative—and I hope to vindicate that characterization of myself later on—there is a certain degree of mellowing on the subject, because the kinds of questions that we generally worry about in the field go very far beyond the kinds of products liability and general tort questions we are talking about here, to the rather netherworlds of intellectual properties and regulated industries; and that is where the lines between what is a conservative and what is a liberal are much more difficult to identify.

However, we are not going to take those strange and vast journeys today. I am going to focus my attention, for the most part, on tort law and I will go back to both these positive and normative descriptions. If you start with the positive question, I think the first thing that you would discover inside this field is that—as best as I can tell—whatever you people were doing thirty or thirty-five years ago before law and economics became a mature discipline, you seem to be doing similarly today. That is, if you were trying to figure out inside the field on a day-to-day basis what transformation, if any, the learnings of law and economics have done in the administration of trials, and in the way in which people like Jim Henderson prepare the Restatement, I would say that there may be some small influence that has taken place, but the overall evaluation of this particular point is

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that the amount of influence that we have been able to exert on the field, for better or for ill, has been relatively small. Of course, when you look at the field, you could always find somebody who is prepared to talk about a cost over here or a benefit over there, and if that is enough to make you a law and economics scholar, then all of you are devotees of the field.

The problem with that particular definition is that it is so inclusive, it means that there is nobody outside the field of law and economics, so that membership in this club loses because of what Groucho Marx said, "I don't want to belong to any club that will accept me as a member."¹ This is probably different. If you have everybody in there, then there is no exclusivity and we do not stand for anything. So I think when we talk about law and economics, we want to say that whether you are for or against a risk-utility test, simply having used or uttered those magic words does not determine whether you become a member of the field.

Well, then if that does not get you into law and economics, what is it that is required? I think, probably, the definition that most of us inside the field would give is that this is an effort to figure out how to get some set of optimal results, given conditions of initial scarcity amongst individuals who have self-motivated behaviors in terms of the way they interact with their fellow man, or at least with strangers. So law and economics, as a discipline, is designed to figure out what is the set of rules which will maximize the sum of consumer and producer surplus in these various kinds of transactions. That is, consumer surplus is the gain that an individual consumer gets over his reservation price—the most he is willing to pay over what he has to pay. The producer is the other side, that is, how much you get above and beyond the minimum for which you are prepared to sell. Law and economics, to some extent, is to try to figure out how you maximize the sum of those two gains, taking into account potential externalities on third parties.

If that is the case, then, now we really are talking about something, and we see why law and economics has a very hard sell inside the profession. If you are going to do it rigorously—and I am not really capable of doing it rigorously—you must start accumulating definitions from other fields and bring them to bear on this, and that requires a mastery of some collateral disciplines. One of the reasons why, in fact, law and economics does not dominate inside the judicial profession—and perhaps it is a good thing that it does not dominate inside the judicial profession—is that the entrance fee that you must pay is relatively high; and if the cost of doing business is higher than that of the next best rival, then by good economic principles, this high-priced alternative will be driven out from the market, and some lower-priced alternative will replace it.

Well, what is the lower-priced alternative that most of you characters are prepared to use when you are sitting on the bench? I heard it today time and time again. When you are faced with a hard question and you do not want to go through the language of maximization, you always turn to the intuition defense. That is, you say, "It is 'just' to do it this way, and it is just not right to do it that way." I think it is improper that this

particular result takes place either way. The great question that we have to ask is: whether or not when people start to use the language of that particular sort, on what did they really rely?—As my old colleague and friend, Dick Posner used to say, “upon an implicit economic logic?” Or whether these judges are simply expressing some kind of rather more indeterminate sentiment which cannot be reduced to economic terms and, indeed, may not be able to be reduced to anything else. I think, as strange as it may seem, one of the problems that one has in law and economics is that this language of intuition is so powerful, so strong, and so easily understood, that most people resist the effort to try to refine and explain it, and to cast it into language which has a heavier economic content.

Let me tell you a little story about my own life—which, I think, brought this point home to me most vividly some years ago. I was sitting at a Liberty Fund conference and was talking about law and economics, and the guy on my left was not Henry Butler who knows all this stuff about game theory and consumer surplus, but it was an English professor. He listened to me talk for about five or ten minutes, and I was going on, and I was really revving it up. Then he stopped me and said, “Professor Epstein, I’ve never met you before, and I have to say that I haven’t understood most of what you said, but I do know one thing. After listening to you for ten minutes, I could get you committed in any state of the union.” I said, “Oh, you want me to say it a little bit slower?” I think his answer to that was, “Don’t bother me with all that stuff!”

In fact, there is an important point here about this story apart from the fact that I managed to escape civil commitment. One of the reasons why people are so reluctant to engage in law and economics language on the bench, even if the judges themselves can understand it, is that it really compromises to their minds—to some extent at least—the kind of legitimacy that their decisions will have in a larger audience of ordinary individuals who understand something about right and wrong, but do not understand anything about optimization of any kind. To the extent that you are either elected or appointed officials in some kind of a popular democratic situation, you are faced with the dilemma of using language which may be more precise on the one hand, and losing your audience, or conversely, using language which may be a little less precise, and keeping your audience with you. In trying to figure out how you may use an economic term— that trade-off between these two things— it is not at all clear to me that what takes place inside the economic theory is, in fact, going to be the dominant solution. So that is one of the real problems that one has to face in this field.

Let us just go a bit further and say, “Now look, are you only going to come here to tell us to trash this field? Can you tell us a little about why it may well be that the economic account does not work so well inside the field as a descriptive of what has gone on?” Here, I think there are some arguments—I do not know whether they are anti- or pro- economic arguments—which explain some of the ambiguities that many thoughtful commentators about the system have had in trying to see whether or not we could capture it to some degree inside a law and economics framework. Of course, the first thing that one notes is that the disjunction between the language that is used on the one hand, and

the efficiency results that are claimed for it on the other; and I think people are generally suspicious that you could always somehow do these complicated vaults, twists and somersaults, and always end up on your economic feet. That is, generally speaking, economists say that the reason you have to know theory is because unless you know the theory, you are going fall astray in trying to deal with particular cases.

Now, it turns out that the positive economic analysis of law says that you people have been doing it right all along, even though you do not know a word about the subject, for which I think the caveat is: if that is the case, then let's say that ignorance is bliss and the less you learn about economics the better we will all be, because after all, if we have managed to get ourselves through the "efficient" solution with a set of ignorant judges, just think of how we could improve ourselves if we spend the cost on your education. We can't, right? So stand up!

I do not think we even mean it in that particular fashion. I think that there really is something else going on. I think the first thing that you start to learn is that if you have tried to figure out whether the rules look to be efficient, you would like to think that there was a set of rules out there that you could target as being efficient or inefficient, but there is nothing more common to the legal profession than the following statement: The majority rule which you have in thirty-seven jurisdictions turns out to be 'X,' and the minority rule in thirteen jurisdictions turns out to be 'Y.'

Now if you really believe in the efficiency of the common law, what do you believe? That the majority rule is right and the minority rule is wrong? Well then you have to explain why thirteen courts get it wrong and thirty-seven courts get it right—or do you believe that both courts are right and that one rule, which is appropriate in Kansas, is completely inappropriate when you get to Nebraska, at which point you have to start to explain why, when dealing with these particular differences, there is something reasonably coherent in the theory which would allow you to break the states down in that particular order. If it turned out that the majority in one issue was the same as the majority on another issue, and the minorities were relatively constant, then it may be that there was some internal logic inside these jurisdictions, which would help you justify the split. However, when it turns out the majority and minority constantly crisscross and overlap in strange patterns, it becomes in effect, very difficult for one to say that the system is efficient when it turns out that it unnecessarily contains certain levels of adhering, non-reducible contradictions.

Things do not get better when you start to see the way in which the system works over time, because typically you see major changes taking place in the structure and the nature of the legal rules, and whenever we speak about legislatures, we always say that no legislature should introduce such a profound change unless it has detail juries, which take into account the empirical and institutional effect of the various rules that have been proposed. You people just do it on a whim—right? You don't like privity? Privity is gone! You don't like contributory negligence and absolute bar? Presto—it disappears! I have never seen a judge give an empirical study prior to overruling a particular case. If

you get that degree of movement inside the system over time, then again, you have to ask the question, "What made the rule efficient in 1960, and inefficient in 1970?"

In fact—at least to this sort of economically-minded law professor—you cannot make the positive claim work here because oftentimes you have your engines working in reverse. That is, if you wanted to determine what is "efficient," it would represent in one proposition the dominance of contract over tort—that is, the ability of people to get themselves out of a legal system of regulation by private arrangement. So therefore, if the common law were efficient, we would start to see huge amounts of "contracting-out" being allowed and encouraged by a judiciary that is so concerned about its ignorance under the circumstances, that it would prefer a system of private order.

Well, you start to look at the modern developments and see that efficiency is on the positive side, and certainly starting with *Henningsen v. Bloomfield Motors*² back in 1960, going through a whole variety of other cases like *Tunkel*³ a few years later, and then *Javins*⁴ on applied warranties of habitability, you see exactly the opposite trend taking place—it is unmistakable. You may be wise, you may be foolish, but you are certainly consistent on this issue. That is, the movement away from contract towards tort and the movement away from private choice to judicial regulation, have taken place; and to the extent that one has a strong view of efficiency, which says that private markets dominate over those subject to public control, then it turns out we cannot get the efficient hypothesis to work at all. The only way that we could get it to work is to explain why all of these private markets turn out to be highly inefficient, at which point again we run into the problem that I have talked about before.

There are two sides of law and economics. Side one, of which I am a member, advocates mutual gains through trade, and encourages contract. If you are from side two, every time you see a contract, you first think of inequality of bargaining, then imperfect information, then monopolistic domination, and finally, you think of some kind of implicit economic duress, so that whenever you see a contract you see a sign of trouble. You have to be able to resolve that underlying tension between your two models of human behavior to answer the questions at hand. That is one set of problems that we have with the descriptive part of law and economics.

There is, I think, another problem that happens, and this one has less of an ideological tone and more of a methodological tone. I call this the problem of "reverse engineering." Let us suppose that you present the following challenge to an economist: Design me an efficient tort system. How many of you think that these people sitting in their offices with their pens and papers and computers, could have ever come up with the kinds of rules that judges, through incremental decision-making, have made over the past several hundred years? I know they could not come up with these rules, because even after you tell most economists what the rules are, they always manage to screw it up because they have not been trained as lawyers. They miss all the nuances, all the stuff about procedure, like the difference between a summary judgment and a jury verdict, burdens of proof and stuff like that. They never quite get it right.

If they do not quite get it right, then how do they know whether the rules are efficient or inefficient? Well, they reverse engineer. So, to the extent that you had the positive theory of law—which says that judges always make efficient rules—the way the game was played, you first told them what the rule was and then they told you why the rule was efficient. It did not matter what the rule was because they had enough tools in their tool kit to always come up with an efficiency explanation. So if it turned out that you had a rule that said contributory negligence is an absolute bar, well, you know that particular rule is efficient because it reduced the number of suits under litigation.

Of course, six years later you people come up with a comparative negligence rule. Now, you know that particular rule turns out to be efficient because it places equal incentives on both parties to the situation to avoid harm so that, on average, the margin of returns will increase over the contributory negligence rule. You see how easily it is to state these things? You can just whip out those explanations as fast as I could whip out those rules and it becomes, in effect, kind of a fetish non-forcifiable discipline. That is, every time I give you a rule, you give me a rule. I can give you an explanation, and if I have enough terms in my equation—I could worry about administrative cost, distributional consequences, incentive effects, coordination gains—all legitimate subjects. You begin to understand very quickly that in this particular game, there are enough degrees of freedom in the economists' set-up concepts, that you only need to tilt the weight a little bit either way and any result you want can come up with some kind of an efficient allocation. That is because markets, in fact, operate differently than judges: When people are out there in the market, spending their own money, they are making their own choices. When they have to decide whether or not the insurance is going to be worth the loss of incentives that it creates, they are going to have to use a business sense to make that an informed judgment. When you people have to do it, or worse, when we have to explain why you did it, we do not have any of those real world incentives upon it. That is true of judges and it is true of academics—talk, to some extent, is cheap.

It turns out that behavior is costly, and what is wrong, in many ways, is that the academic version of law and economics is through these *ex-post* reconstructions. It turns out that all too often you get yourself into the land of nirvana. You give me a rule, and I will explain to you why it is good. Of course if you can do it that way, you can also flip it around. I can prove every rule is inefficient by exactly the opposite argument. Instead of stressing Point A, I stress Point B, and now I can say that that first rule is inefficient because . . . and the second rule is inefficient because . . . and the third rule is inefficient because . . . and so on. If you get that much degree of freedom, you do not want it.

The third point about these models, on the positive side, has to do with a somewhat different problem related to the one of reverse engineering, but nonetheless conceptually distinct. It is the question about the robustness of the model with respect to the underlying conditions under which it takes place. One of the things that is quite striking about much of what you start to see in game theoretical literature is the following situation: make me assumptions A, B, and C, with players D and E, and payoffs F and G.

I can tell you that if the original assumptions are good, then it turns out that the players, in acting out their particular self-interested game, will get to a result which will maximize a given consumer surplus. The truth about the matter is—I cannot stress it to you since most of you did not take economics in the last ten or fifteen years—the amount of the basic price theoretical structure that takes place in preeminent graduate departments of economics today depends very heavily on the game theory as a way of organizing. I mean, it is really quite extraordinary how much this has transformed the business of law and economics. At some level, it is an unrivaled good, but at other levels it turns out to be problematic. This is because you do not know the power of the assumptions under which the particular model is going to work.

So one assumption that we start to make is that in determining whether contributory negligence, for example, is an efficient rule, we will assume that individuals can calculate the cost-benefit analysis that they must make, and we will be confident that a jury after the fact will make the same kind of analysis. Now if you do that, you can make certain kinds of stunningly optimistic conclusions, one of which is that people are never negligent because it is always inefficient to be negligent, therefore, people will always avoid it. So, therefore, we have no lawsuit because, since the people are never negligent, and since there is never a mistake inside the judicial system, nobody ever has to sue anybody under a negligence system.

Now, I think most of you will say, “Wait a second! I’ve seen a lot of dumb people in my courtroom, some of them are plaintiffs and some of them are defendants; some of them are young, some of them are old; some are male, some are female, but if you want to tell me this, then you’re really living in a dream world!” But in fact, you are also living in a world that the economist, if he thinks about it, can model. This is how you model: Once you recognize that error can come into the system, then, in effect, all of the optimistic assumptions that you make about behavior are going to unravel, given the accuracy of the economic model. So if the standard contributory negligence model says that the plaintiff will always be efficient because the only way that he could avoid not recovering, is to avoid being negligent. Once the defendant knows that the plaintiff is going to be efficient, the defendant will be efficient because he wants to avoid primary liability. So, therefore, you end up with the optimal outcome. Introduce uncertainty into either of these two cases, then in effect, neither person knows what the other person is going to do, and suddenly you now have a series of highly uncertain probabilistic choices, and what game theory tells you about all complex situations—I could teach you the whole subject in one word—indeterminate. We do not know the answer. We do not know whether it is going to be an optimistic result, a pessimistic result; whether they are going to go left; whether they are going to play right; whether they are going to go up, down, inside or out. Nobody knows.

Now, what does that tell us about the legal system? Well, here, in effect, is a positive matter that starts to tell you the following things: The traditional, so called, “left wing” criticism of the contributory negligence system, was that it was a lottery and

nobody ought to play it. Of course, to the extent that law and economics is wedded to the efficiency of the common law, they would say all these lottery people care only about the distributional side of the picture and they do not care at all about the efficiency side of the picture and so, therefore, we ought to deplore it.

Now, if you take a slightly broader view of what law and economics is about, and move slightly away from the game theory to a bit more of the institutional understanding, you will get a very different function of what the tort system looks like. In 1982, I wrote a paper on the history of the origins of the worker's compensation system,⁵ and quite by luck, I happened to come cross a case which talked about the role of assumption of risk in employer liability cases in England during the 1880s.⁶ Much to my surprise, I discovered in that case not only a rule which says that assumption of risk was an inappropriate defense in these cases and it had not been displaced by the Employer Liability Act,⁷ but I also found a set of contracts that had been developed in the mining and railroad industries, which actually figured out how the risk was going to be allocated.⁸ I discovered that these people had no use whatsoever for the tort conceptions of negligence and contributory negligence in any combination whatsoever. In fact, they had, through voluntary agreement—and these were workers represented by unions so that the exploitation issue is, I think, not a serious one, even if it would be without it—adopted a voluntary version of a worker's compensation system.⁹ That system essentially had broad coverage, no liability turning on fault, very few affirmative defenses except those associated with willful misconduct, and a damage award which was systematically designed to undercompensate people after the fact. Why would they do this? They did it because these people knew something that you people did not know and something that the economics professors did not know either—they found that the lottery argument was probably a fairly accurate description of what took place inside the tort system; that all the indeterminacy that you could learn from game theory was true, and that a system in which it turned out that you managed to increase the rate of the flows, reduce the administrative expense and capital liability, would on balance work better administratively.

What about the incentive problem? This is one of the other things to which I referred, and in an odd sense, these guys thought about that as well. The genius of the system is undercompensation. I want every judge to understand that undercompensation is a virtue, not a vice. I know you do not like me for saying it, but let me just stress it, because undercompensation in the *ex-ante* world means that the defendant still knows that he is going to have to pay a lot of money if there is a work-related accident and so he is going to have a lot of incentives to take care. By the same token, the undercompensated plaintiff knows that he or she will also be taking risks for which compensation will be insufficient, and so, therefore, he or she has an incentive to take care as well. In some cases, to paraphrase Guido Calabresi's famous example, if you are a great pianist or violinist, you don't go work in the mines because you know what undercompensation means to you.¹⁰ So the worker's compensation system has an additional effect, a selection effect, by getting certain people into kinds of occupations such that their *ex-post* losses

are likely to be smaller, and keeping other people out of those systems.

So if you understand institutionally what went on through that voluntary arrangement, you can start to tell a story about efficiency and about the relationship between common law rules and private arrangements, which does support some of the private market-oriented solutions that I have talked about, and which falsifies many of the other accounts on the opposite side of this issue. This is because the conventional account of contract and assumption of risk in the industry and in the academic literature was that we told these workers they assumed the risk when they came on the job, take it or leave it, and if they died it was forever their own peril. But in fact, what we know—and we observed it—is that assumption of risk was important, not because it was pushed to the extreme, but because it set the legal framework which allowed people to correct legal mistakes made by the so-called “efficient” common law system in a way that would be immune from subsequent judicial scrutiny.

So now in effect, when we start to get to the normative side of the situation, I think we can start to see where we can talk about law and economics. That should indicate what I think people can do well and what I think they can do poorly through the judicial system, and why I think that most of what Jim Henderson has worked so hard to put together in a responsible, establishment, and enlightened fashion, is a big fat mistake. That’s what I want to say. It is not a small little error, but a fundamental mistake for which you all ought to be mistaken. He is exonerated because he is a Restatement fellow and he has to put this stuff together. Gary is exonerated, all the Restatement people are exonerated. It is the system that matters, and this lonesome voice in the wilderness is going to try to explain to you why, fundamentally, he thinks the entire enterprise of modern law is, in large measure, misguided. I have five minutes to do that, but I think that is all it takes.

First, if you want to use law and economics directly, there is a fundamental cut, one which I have advocated for almost thirty years now, in the kind of cases that you have to worry about—the classic cases or stranger cases. Those, for example, that deal with ultrahazardous activities and bombs that explode, the occasional bystander case in products liability, and the traditional trespass case of one form or another. Under those circumstances, particularly when transactional costs are high, we have a situation, without legal intervention, where we know that there is a fundamental asymmetry in the incentives under which every individual labors. You internalize all the gains of your own actions and you could export large measures, large percentages of those gains on other individuals. To the extent that you get all the benefits and only a fraction of the cost, you will systematically overproduce in that particular instance. The function that judges can rightly discharge is to tell people that when they start throwing these costs on other individuals, there must be a way to bring the costs back into the responsible party’s account.

At that point, there is an enormous debate that takes place in the academic literature between negligence and strict liability, and I have always been a strict liability

fan in these cases, but I have to confess, I do not think it is that critical or important in the grand scheme of things. I think both of those systems in one way or another—as I tried to explain in that section of my treatise that I distributed to you¹¹—in effect, get you to about the same point on incentive behaviors. You cannot ignore the welfare of other individuals when you act under either a negligence or a strict liability system if these things are properly understood and conceded.

So at this point, we now go back to the positive analysis of law and economics and we come up with a rather different conclusion of the subject than I had before. The reason you people are allowed to indulge in every sense of equity in choosing between negligence and strict liability in these stranger cases, is because the *ex-ante* effects of the rules and the choice between them are sufficiently small that we are willing to trust this to judicial discretion. That is, when you have a case in front of you, *ex-post*, it may well be that the choice of rules is going to be absolutely critical to whether the plaintiff does or does not recover. As a judge, it is your responsibility to pick the best possible rule, but if you are going to ask whether you can see a genuine tremor in the eyes of the population if you pick negligence or strict liability, in these cases, the real effects on most individuals are so difficult to figure out one way or the other, that you can safely be left to make whatever mistakes you choose to make, and that is the key.

Now we come to this other classic case. It is a consensual case. These are cases, in effect, where people get together, as in my worker's compensation example, and try to figure out by contract how they want to allocate the risks among themselves. It turns out that we do know from the debates over automobile no-fault, as we get into the tort system, that once you get to that debate—the size of the stakes that come from the abolition of the tort system and the substitution of a straight no-fault compensation system—that it is big enough, and I use the same test. The legislature will cover that, and in fact the newspapers will want to know whether it is going to be introduced. The size of the shift that can take place between regimes is very large, and of course when you do it through legislation, you have no idea which magnitude is moving in what direction.

By private contract, you get those incentives correct more often than not. I do not wish to be an absolutist on this thing, I just wish to plead for the comparative advantage of market over judging. I plead that because folks have their own money, their own recruitment, and their own services on the line, they will do a better job in making long-term projections of costs and benefits than would judges. So, this means that if you are trying to figure out which of the two issues of the nineteenth century really has bite, it is not the negligence versus strict liability debate, although that was often treated as being a “you break your society” kind of issue. The real question is whether we allow assumption of risk as a defense presumptively, but strongly, in all kinds of situations where there is a consensual arrangement between the parties.

Here is why I think all the *Restatements* are wrong. They all consider assumption of risk as something to be taken into account. I think it was Mr. Palmer who referred to “the parity of the multiple factors.” I can show you under a risk-utility analysis twenty-

seven factors, all of which are relevant and none of which are decisive. That cannot be the way you want to be running a legal system. You must ask yourself the question, "Do we want anybody to say as nicely, humbly, and respectfully as Jim Henderson said that when it gets to a jury, they are trying to do the right thing under the circumstances? The jurors may not know any more or less than we do, but we will let them do it and we are not going to reverse them?" I believe you guys are asking the wrong person. You are asking the question of whether an ignorant jury is better than an ignorant judiciary when dealing with a problem that neither knows anything about. This does not impress me as being the right kind of debate to undertake.

The right debate is whether or not you think contracting-out is going to do better or worse than a system of externally controlled results. If I am right—and I treat the worker's compensation case as an illustration of how it did, in fact, historically work, so I am not just trying to be a Chicago economist telling you what happens on a blackboard, I am describing to you a pattern of behavior inside an industry—then, in effect, I think we can see why the system has gone completely haywire. What we do is we build in one new cause of action after another. It turns out we cannot use strict liability because nobody knows how a product is to be strictly conceived as defective. You have to figure out what change would have been made. It must have some degree of reasonableness in there somewhere, but then once you have to get it to reasonableness, so that you have lost the hard-edge nature of the strict liability rule, none of you could tell me what are the factors. So what really makes you erudite today is to figure out how you could win from the list.

That cannot be right, I say to myself. The administrative cost of that system has got to be nightmarishly high. The ability to understand the way in which people are going to organize their incentives, if that turns out to be the rule, has to be extremely low. So if you get lousy incentive effects and lousy administrative effects, what do you get? Equity? Well, if I thought I knew what it was, then I would be in favor of it, but I think one of the things that we must be aware of is that unless you could give a precise content to that turn, having shown some very serious fundamental structural difficulties with the level of judicial intervention that we now have, and sanctify it under the various Restatements, we are paying a very high price. So what I am arguing for is not a refinement of the rules that operate the system, but for cleansing the system of all the rules that you people put together and to try to have the "Epstein Restatement of Torts" which says, "Any rule that we devise, competent adults can get rid of by private contract, and the rules of whether these contracts are good, are no different from those which determine whether you have decided to buy, with or without warranty, a loaf of bread or something of the sort." Now that is a really radical reform, and I think, oddly enough, that while law and economics does not tell you much about whether contributory negligence is a better defense than comparative negligence, it does tell you a lot about the choice that we have systematically been unwilling to face.

So why does it turn out that I lose? There is another branch of law that I want to introduce to you. How many of you have heard of the two magic words in conjunction

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with “public choice?” Now, I know the academics have heard of that. But this is a branch of economics which has nothing nice to say about the world at-large. Public choice does not mean deliberative democracy works. The field is designed to say that if you assume that individuals are self-interested, with resources scarce, in the manner that I indicated to you before, how are they going to behave when this method of allocation is in private contracts, but is some kind of a voting or deliberative price? It turns out that the general tone of the field is highly pessimistic about the ability of democratic institutions, through voting mechanisms, to organize themselves in sensible fashions. So many of the things that one wants to say about this system are not accurate.

If you are trying to figure out why the system continues as it does, do not ask about the justice of the case, because I do not think you are going to find an answer. Ask about the “intraspoek” politics that are behind it. One of the reasons why I am proud not to be a member of the ALI—although I will always consult with them on a spot basis but I will not be a member—is because I think it is just ridden with intraspooks of various types which take over the process. I think what happens is that you do not get the kind of independence that you need to make the considered judgments in these areas. So here I am, and I now give you the ultimate dilemma of an academic: if you really speak your mind, you discover you have no friends, and, therefore, only scant influence.

If, in fact, you wish to work within the system, what you have to do is to remember that you are restating the law. You are not reshaping the law. We have to live by the constraints under which we labor. So there is now, I think, a very powerful division of labor that takes place. There are people, I think, who are trying to do the right thing by way of incremental reforming in light of all the constraints under which they work, and then there are the unreconstructed rebellious types who sit outside the process and basically say, “Maybe we are wrong, but we think, in effect, that the divide that we have to deal with is far vaster, far more complex and ironic, than the one you face.” Law and economics mostly addresses the kinds of questions which the political process regards as untouchable.

So go back to your chambers and make your decisions, but always ask yourselves, “Why isn’t this a freedom of contract issue?” That might well change, at the margins, the way in which you apply the massive apparatus that the state has put at your disposal. Thank you.

Editors Note: Following his prepared remarks, Professor Epstein engaged in a discussion with members of the audience. The following are his responses to various questions.

There is a body of literature out there which I will refer to as the selection of disputes for litigation and the terms on which settlement take place. What happens is that you people are all bargaining in the shadow of the law. Jim Henderson has put out his design defect rule, and that rule says, in effect, that if you can show that there is a

reasonable alternative design, then the plaintiff is going to have some mileage. If not, then they will have none. When people bargain, they bargain in the light of the successive day to succeed, conditional upon the rules that are in place. They are trying to do exactly what you said.

Given these rules, settlements save litigation costs and reduce uncertainty for both sides—that is a plus, right? Unless people are crazy, we would expect them to move in that direction. What keeps them apart? Well, the answer is something which we have not talked about thus far today—but which some of you, if you have not heard about, you have certainly lived through—it is called “bilateral monopoly.” It is not a competitive market. In a bilateral monopoly, if I do not like settling with this defendant, I could just pick somebody else to sue and settle with him. I mean, you cannot do that, and so the fact that you have one buyer and one seller, one plaintiff and one defendant, makes the negotiations tough.

We are asking, “Given the difficulties that you have in negotiating a bilateral solution under these at-risk bargaining conditions, are the potential gains large enough to overcome those difficulties?” The answer with repeat players is surely, “Yes.” However, I am concerned about which cases get into court and what is going to be the settlement point. Under those circumstances, what you say is true of any legal system. No matter how stupid, no matter how profound it is, if we in fact had rejected every one of Henderson’s and Twerski’s moderation reforms, we would have exactly the same process: ninety-five percent of the cases would settle, only we would have twice as many cases as we have today. If you went my way, you would probably have ten percent of the cases you have today and ninety-five percent of those would settle, but for a different amount. So I think you must ask yourself two questions, and keep them distinct. The first question is, “How do you maximize the positive conditions working within the system?”—which is what you are talking about. The second question—my question—is, “What should the system look like?” Those are two very different questions.

The worker’s compensation system was reached by extensive negotiation between the unions that were powerful in England at that time and the manufacturers. It was only reached in dangerous industries because in the less dangerous industries it was not worth doing. But let me go back to your other case and tell you why I think you are wrong about something.

For those of you who want to read about it, there is a decisive, I think, recitation of what she said in the 1986 *Journal of Law and Contemporary Problems*, in a piece that Glen Robinson wrote on the subject.¹² But here, just put yourself in the following position. First, we want to look at this exemption. Now we just talked about a guy who was three-quarters dead. One way to deal with that is to ask yourself whether or not this was a provision which was imposed specifically on that person, or whether it was the same kind of release that was demanded of your most upper class individual. I think, with respect to virtually all of these hospitals in California, what happened is that they did not care about releases prior to about 1955 or so, because the caseload was sufficiently pro-

defendant that they had no particular reason to want to contract out of it. But after many cases in which it seemed as though liability was about to expand, then they started to think about contractual issues. The usual rule is, if in fact you have a nondiscrimination situation in which the contract terms that you get are no worse than those that other people who are competent are getting, there, in effect, you cannot tell the story about how it is that emergency conditions effectively erode consent. Whenever you are dealing with large institutional arrangements like this, I think you will usually find that those considerations will be satisfied. Why? Because internally, it turns out that most hospitals cannot deal with multiple systems of liability within the patient population. They have to have a single standard to know how to make their internal management decisions one way or the other.

Second consideration, why do you say that because you are asking him to waive the liability that this is stupid? I come from a medical family. My uncle, for example, is a distinguished neurosurgeon, and he has told me of countless incidents where people come to him on bended knees to say, "Please, operate on me! I will waive any kind of liability that you talk to me about because I think that you're a great surgeon and I'd rather take my chances with you without liability than take my chances with some hack, even though I've got lots of liability protection afterwards!—I'd rather be alive and healthy, than dead and compensable!" Well, what's wrong with that choice? These people have got it right! The calculation you have to make is whether you are better off now that you are three-quarters dead, taking a doctor without liability (who has a ninety-eight percent success rate), or having a situation in which you just disappear?

The gains from that trade are so enormous, that any one of you would waive the liability to get the surgeon of your choice. You do not have to be poor and ignorant of that choice. You just have to be rational and sensible in order to make those calculations. So I think, in effect, if you run the expected utility, the question you want to ask is whether there is any way that the firm can find out the creative system of liability which will cost it slightly, and give you enough confidence and security that it will improve the situation. In principal, you might be able to find it, but history has suggested it does not work very well. The arbitration systems in California, for example, have been notoriously inefficient with delays and awkwardness.¹³ The jury trials have been unspeakable in the sense that nobody knows exactly after the fact how you reconstruct an accurate rendition of the uncertainties that existed *ex-ante*. So in this kind of world, my view about it is that these are exactly the cases in which you want to have contracts. In fact, I would tell you without doubt that—ignorant as I am—you give me the doctor, I'll give you the terms any time. Maybe this is not an intelligent decision, but I am telling you that if my life were on the line, I would much rather choose the doctor upon reputation and other constraints, than have a system of liability.

The cost of the system of liability is that the availability of the physician that I might want is going to be deterred by that, and that is a hidden cost which is very high and ought never to be disregarded. One of the things that judges have to remember is that the

ex-post cases you see are the cases where contracts fail. The *ex-post* cases that you have to think about are those cases in which they are never formed and the people are excluded by virtue of the fact that you do not have anybody offering the service that you want, resulting in somebody dying on the street. So remember, it cuts both ways.

One of the things I asked you to read was a bit of economics by Dick Posner,¹⁴ who is talking about disclaimers, and he gets it completely wrong. I mean, he said that there is a good legal argument which says, in effect, that we should disregard disclaimers because in those cases where the risk of injury turns out to be minute, people will not insist upon it because they are buying just one Coke bottle.¹⁵ Whereas the producer, knowing that they are producing millions, will get a huge amount of gain out of it, so they are willing to tough it out.¹⁶

Now, in fact, I have actually worked with some of these mass production contractors and I will tell you, there was a cigarette company, a client of mine, and I said to them, "Hey, I have this bright idea. Do you want to put a disclaimer on your package which says 'all smokers take the risk of impurities that may work their way into a cigarette package—so if there is cyanide inside the cigarette it's at your risk?'" They looked at me like I was the man from outer space. They could not think of any act which would more quickly destroy the value of their brand name than the use of that disclaimer. At the moment you put that disclaimer on there, the consumer, instead of thinking that there is a one in a million chance that it is going to be fully funded, is going to think there is a one in a thousand chance it is going to be unfunded. Their perception of the risk is going to change by virtue of the disclaimer, and they are going to flee from that product.

So under those circumstances, you want to allow the people to put the disclaimer on there because when they do not, it starts to convey some very powerful information. I would tell you as a business matter those are not the cases. But there are other cases you must worry about, and when you take the automobile case, you just follow the progression. In *Henningsen*, they had a limited warranty type situation, and looking at the facts, it sounds like the kind of case in which even I would want to sue.¹⁷ It was a case in which somebody took a new car on the road, turned the steering wheel, and the whole thing went awry and they landed in a tree.¹⁸ I mean, clearly your intuition about that case is that there has got to be something done. But now suppose I were to tell you—not that I know this—that most people do this as a matter of psychology and systems analysis. Say you are trying to figure out whether there are two kinds of errors. One of them is a guy falling asleep at the wheel, and the other is a kind of a quality control error in manufacturing such that you forgot to put the nut in the bolt under these circumstances. What is the likelihood, in effect, *a priori*, that it is going to be one as opposed to the other? Interestingly, if the human factors were to determine this thing, it is almost overwhelming in its insistence that it will be individual error.

As we know, people are subject to all sorts of courts, as opposed to system error where, in fact, you can eliminate many of those quirks by assembly line procedures, redundant inspections, and the like. Now if you thought that the rate of error of a jury was

sufficiently high that you had so many false positives, that is, attributing things to the product that did not go there, the optimal solution is, in fact, no liability, reputational loss, and maybe some kind of an *ad hoc* position.

Is there any way to improve upon this? There is, and I will explain with the case I hate most. In terms of public liability development, there is a 1974 case, *Collins v. Uniroyal*, which was decided in New Jersey.¹⁹ Uniroyal said that they were going to issue a warranty without asking the customer to waive anything²⁰—so, if you happen to die when one of our tires fails, we'll pay you \$10,000 whether or not the tire was defective. So they have extended liability beyond anything that Jim Henderson in his worst moment would dream as a potential source. So what happens? This contract is unconscionable, ladies and gentlemen, under section 2-719 of the Uniform Commercial Code. Why is it unconscionable? Because there is a \$10,000 limitation. But was it not a package? We wanted broader coverage and narrower liability. We are trying to replicate that worker's compensation environment so as to signal people that your tires were really very good. Once you invalidate the damage position, now it becomes a world in which there is infinite liability for anything that happens on a tire, and all these warranties are withdrawn. So I think if you are trying to figure out what market behavior looks like, judges and legislators have to remember, that you have essentially killed the market-involuntary warranty with one decision. No sane manufacturer will take the risk of giving that kind of warranty if it turns out that it is going to get the unconscionability split.

This is no laughing matter. I have been asked many times, for example, by pharmaceutical companies, "Is there something we can do such that if somebody dies of a stroke when they take our birth control pills we'll give them \$10,000, no questions asked?" And I say, "Sure you can do that, but you must remember that \$10,000 may become \$10,000,000 because somebody is going to invalidate that type of clause. They reply, "You know, that's right, professor!" And I say, "I don't know anything—some judges will, some judges won't, but do you want to take your chances?" Then they put the thing back in the drawer and they don't do it.

So, you essentially have a view of the market in which nothing is forthcoming voluntarily, and my answer to you is that the market looks that way because of what judges have done to the doctrine of unconscionability as applied to products liability. They have killed off all motivation. At this point, if you try to move an inch voluntarily, you will be pushed a mile involuntarily, and nobody can stand that kind of a risk.

Having seen that take place with respect to products liability and also forgetting in New Jersey years later with respect to insurance coverages, I can tell you exactly what advice you give to manufacturers and insurers. If these people will be sitting on the bench ruling on those cases, you do not want to give them the topic. You just, in effect, play hardball from beginning to end. I think you have to understand that the *ex-ante* effects of the rules we are talking about, whether judicially created or legislatively created, have killed the voluntary market in warranty.

This is not a hypothetical market. The worker's compensation case that I talked about in the nineteenth century was not entered into by small fly-by-night companies. It was International Harvester, B&O Railroad, and General Electric. Their cases were never in the courts because they worked this private system out through contract. So it was a full-scale operation. If you want evidence of it, go back and read the Wainwright Commission where they report on the development but do not understand why it is there, then promptly say that if one private firm can do it, all private firms should do it.²¹ That is crazy because you do not know what the cost conditions are in the various firms. You cannot use worker's compensation in all systems. Why? Because in some cases you work by team production, at which point it is an efficient model. If you work individually so that workers go out into different parts of the mine alone and there is no cooperative behavior, it is an inefficient system. So if you saw 100% penetration of this particular contract term, it would mean that the market is much more homogenous than it is, which again shows you the dangers of judicial rules. Not many judges are sufficiently sensitive to the variations in industrial organizations that require individuation. So I am in one sense an undying Chicago supporter when I say that the danger of regulation with respect to consensual industries is captured by the phrase "one size suit fits all"—and if you look around this room, you know it's wrong.

If you were right, you would be right. But let me explain to you why I think you are wrong. Another one of Epstein's principles is: you must learn when to quit. First, judges have an extremely important function that they share with legislators, even in my world, which is to try to articulate the set of default rules that they would be prepared to apply. Oddly enough, most of the firms that take the initiation on contracting-out, want to have default rules which, in fact, presuppose some degree of liability, at least with the standard kinds of manufacturing defects that we are talking about. The cigarette companies, for example, would insist that they be held liable in the event that the contaminants in their cigarettes caused the death of their consumers. They would not want any other rule. So you set that, and one of the things that you discover if you set the presumptions right, is that it turns out that in a large number of cases there is, in fact, going to be no contracting-out because the individuation that you talk about is, in fact, a cost which is borne by the firm. If you are a firm which is known to have highly idiosyncratic deals with this group or with that group and so forth, you cannot mass market. You would kill your brand. So that is a powerful constraint on the level of individuation that the firm would take place.

The second thing is really an antitrust problem in many ways. Either way, that is, when you start to see identical firms across members of a given industry, the great advantage of that is that they no longer have to compare on terms. They can only compare on price and quantity. So in one sense, at least, it turns out that it is a good thing that General Motors, Ford, and Daimler Chrysler, all have identical warranty provisions, because if they have the same provisions, it means there is just one less element on which you have to run a comparison. On the other hand, and this is why it is a serious problem,

you have the very serious question as to whether there might be some kind of monopoly collusion going on inside the industry which would give forth genuine kinds of antitrust concerns.

To deal with that, there is, again, a private response, which is a limited exemption under the antitrust laws for various kinds of standard organizations which have in their membership the various firms whose products they sought to regulate. So if you start to do that, then you could get standard track, standard voltage equipment, and standard kinds of warranties, perhaps, being developed for the product in question. I think, in effect, that even though I am in favor of unlimited degrees of individuation, it is something which is an invitation that many firms will decline.

So situations, for example, that lawyers have often treated very similar to malpractice situations in the products liability situations, in many cases, raise radically different market strategies and adaptive behavior. One begins to see that, for example, when the judge or somebody creates the question, and quite correctly, decides that if you distribute a product to a physician and the physician's going to individuate the information, the last thing that you want to do is to put the duty to inform upon the supplier of the product when all that subsequent information has come out in the ordinary course of business.

I would say that another one of my pet peeves about the bench, is that because it could always find out there are some cases where it adheres to a rule that says FDA warnings are necessary and sufficient, they solve all your problems, but occasionally they screw up. However, the alternative may screw up more, and you really want to recognize that the downstream correction that could be created through the market, or through the internet today is not that much more efficient than any amount of *ex-post* correction that you could take place for judicial behavior. So I think that everything you say is correct, but again, what has to matter, is that it is the same mistake that I have heard three times. Each of you, no matter what you are talking about, whether it is the warranty, the settlement, or the individuation, presuppose that markets will operate in a certain direction and come up with certain results. The truth about the matter is that if you would understand the market behavior a little bit better, you would recognize that the descriptive consequences that you rightly deplore, are deplorable precisely because they are not going to happen. When they do happen in some cases there may be other explanations that come into the situation as, for example, the court's erroneous explanation which may—but not necessarily does—explain part of what is happening.

If you want to find the definition of a perfectly efficient competitive market, it is your supermarket. One of the things that you discover is—whether you are a judge, a mafia member, a poor person, or a rich person—it's Ajax five for ninety-nine cents. Right? The answer is that this market is enormously efficient because: a) you get rid of haggling costs, and b) the take it or leave it offer, which you find inflexible, is not a bad thing, it is a good thing. It means, in effect, that you are not going to get whipsawed where you are paying first and someone else is getting a secret rebate. If you understand

this thing systemically, of course multiple purchases and buyers of these kinds of goods, the standard contract which John Wannamaker introduced allowed branding to take place inside the retail industry. The question that you have to ask is not whether the contract is take it or leave it. The question you have to ask is whether the contract is efficient or inefficient. So, it seems that you must ask two different questions. First, the structural question is whether you think there is really an antitrust violation that exists. Because one of the things that a take it or leave it contract could indicate is that you have a strong cartel in which nobody is going to cheat on price, nor would we want them to cheat on price. But that is an antitrust concern, it is not a standard form contract. It does not have anything to do with large or small print, it has to do with industry structure on these particular cases. So once you know that is there, then you do not have to worry about it.

Second, one must determine whether there is an effort on the part of the seller, who is giving the take it or leave it proposition, to explore some information deficit on the part of buyers such that a risk which he knows to be large will be perceived by the other side as small. My answer to that is, if in fact he is trying to do that, some other firm will come up with another standard form contract with slightly more favorable terms for the customer who will compete away that particular advantage. So that even the information stuff is best handled by new entry into the market rather than being handled by *ex-post* judicial invalidation. In fact, years ago I did this piece called "Unconscionability: A Critical Reappraisal," in the *Journal of Law and Economics*,²² of course an appropriate place for it, in which I went through standard contract terms that had been declared "inefficient," by various courts. I tried to say that if you really understood how the industry operated, that these causes in fact had the general effect of reducing the cost of credit, increasing the availability of product, and that by striking them down you were engaged in the following mistake: the help that you tried to extend to a given member of the class *ex-post*, is in fact inimical to the interests of the members of that class *ex-ante* who do not know whether they are going to be the people who do or do not pay their debts. So that my answer to you is this: If you really want to help deadbeats and hurt honest debtors, you should invalidate the standard form contract.

MR. GERBER: Richard, thank you very much, that was a lot of fun.

Notes

1. GROUCHO MARX, GROUCHO AND ME 321 (1959).
2. Henningsen v. Bloomfield Motors, Inc., 161 A.2d 69 (N.J. 1960).
3. Rayex Corp. v. Federal Trade Comm'n, 317 F.2d 290 (2nd Cir. 1963).
4. Javins v. First Nat'l Realty Corp., 428 F.2d 1071 (D.C. Cir. 1970).
5. Richard A. Epstein, *The Historical Origins and Economic Structure of Workers' Compensation Law*, 16 GA. L. REV. 775 (1982).

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6. See *id.* at 794 & 819 n.44 (citing *Yarmouth v. France*, 19 Q.B.D. 647 (1887)).
7. See *Yarmouth*, 19 Q.B.D. at 657 (citing the Employers' Liability Act, 43 & 44 vict. ch. 42 (1880)(Eng.)).
8. See Epstein, *supra* note 5, at 793.
9. See *id.* at 794.
10. See GUIDO CALBRESI, IDEALS, BELIEFS, ATTITUDES, AND THE LAW 24-25 (1985).
11. See RICHARD A. EPSTEIN, TORTS 85-104, 382-84 & 432-33(1999).
12. See generally Glen O. Robinson, *The Medical Malpractice Crisis of the 1970's: A Retrospective*, LAW & CONTEMP. PROBS., Spring 1986, at 5.
13. See generally, Morton H. Orenstein, *Mandatory Arbitration: Alive and Well or Withering on the Vine?*, 54 DISP. RESOL. J. 57, 58 (1999).
14. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 6.6 (5th ed. 1998).
15. See *id.*
16. See *id.*
17. See *supra* note 2 at 74 (1960).
18. See *id.* at 75.
19. *Collins v. Uniroyal, Inc.*, 315 A.2d 16 (1974).
20. See *id.* at 18-19.
21. Report to the Legislature of the State of New York by the Commission Appointed Under Chapter 518 of the Laws of 1909 13 (1975). (Inquiry into employers' liability and other matters).
22. Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293 (1975).

Topic I: Products Liability

Bill Wagner
Stephen G. Morrison
Robert L. Habush
Charles H. Mollenberg
Lars Noah
Richard A. Merrill
Mark M. Hager
Hildy Bowbeer
Bill Wagner
William A. Dreier
Ellen Wertheimer
David G. Owen
Jerry Palmer
John M. Thomas
James A. Henderson
Aaron D. Twerski